

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE**

In re:

Bk. No. 01-12829-JMD
Chapter 11

River Valley Fitness One
Limited Partnership
Debtor

River Valley Fitness One
Limited Partnership
Plaintiff

v.

Adv. No. 03-01443-JMD

City of Lebanon,
Defendant

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MEMORANDUM OPINION

I. INTRODUCTION

Pursuant to 11 U.S.C. § 505(a), River Valley Fitness One Limited Partnership, the Debtor (the “Debtor”), commenced this adversary proceeding against the City of Lebanon (the “City”) seeking to have the Court determine the Debtor’s tax liability to the City for tax years beginning

April 1, 2001, 2002, and 2003 and any subsequent tax years and reduce the Debtor's tax assessment to reflect the market value of the Debtor's real property adjusted by the City's equalization ratio. After a four-day trial, the parties submitted post-trial memoranda and the Court took the matter under submission.

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. BACKGROUND

On September 11, 2001, the Debtor filed for bankruptcy protection. On September 29, 2003, the Court entered an order confirming the Debtor's plan of reorganization (Doc. No. 572) (the "Confirmation Order"). Pursuant to the Confirmation Order and the terms of the plan of reorganization, the Debtor made monthly post-petition tax payments of \$10,334.00, into an escrow account for the benefit of the City, to cover the post-petition tax liability for 2001 through 2003 plus interest at 5.75%. On November 6, 2003, the Debtor commenced this adversary proceeding to determine the Debtor's property tax liability owed to the City.

The parties entered into a stipulation on March 19, 2004 (the "Stipulation"). In the Stipulation, the parties, inter alia, agreed: (1) the Court has jurisdiction to determine the tax liability only for tax years 2001, 2002, and 2003 based on state law standards; (2) the Court need only decide the value of the Debtor's real estate for property tax purposes as of April 1, 2001, for the 2001 tax year, and April 1, 2002, for the 2002 tax year (the "Determination Years"); (3) the

value set for the 2002 tax year would be used to calculate the 2003 taxes; and (4) the City would use the equalization ratios established by the New Hampshire Department of Revenue Administration (“NH Equalization Ratios”) for the 2001 and 2002 tax years. Accordingly, the issue before the Court is the determination of the market value of the Debtor’s real estate for the Determination Years under New Hampshire law.

A. Debtor’s Real Property

The Debtor owns and operates a fitness club known as the River Valley Club (the “Club”), located at 33 Morgan Drive, Lebanon, New Hampshire (the “Property”). The Property is comprised of a 53,834 square-foot, two-story athletic club on 6.09 acres located in the Centerra Research Park (“Centerra Park”), on Route 120, across from the Dartmouth-Hitchcock Medical Center. Five competitive facilities exist within a seven-mile radius of the Club. The land and buildings, which constitute the Club, are assessed by the City at \$4,395,700.00. Because the equalization ratio for the City was 88% in 2002, the assessment is equivalent to a market value in 2002 of \$4,995,113.60.

Constructed in 1998, the Club has a capacity of between 3,500 and 3,700 members, but active membership appears to have leveled out at between 2,400 and 2,500. The key features the Club offers are: an outdoor pool, indoor pool with waterfall, lap pool, and co-ed whirlpool; squash and basketball courts; a rock climbing wall; separate studios for Yoga and Pilates, and two aerobics studios; large men’s and women’s locker rooms each with sauna, whirlpool, and steamroom; weight training machines, cardiovascular equipment, and a women-only training area; a childcare facility that opens onto an outdoor playground; a beauty salon; an area with a large, stone fireplace and food preparation areas previously used as a café; and a spa that offers

massage and hydrotherapy treatments. Additionally, during the Determination Years the Property housed offices that were leased to a neurologist and a physical therapist.

In 2001, a broker who specializes in the health, fitness, and wellness industry attempted to market the Club nationally. The commission-based broker ceased sales efforts after three months because, although no minimum price was set, no prospective buyers sought to view the Club or make an offer. Additionally, a principal of the Debtor attempted to sell the Club to the nearby Dartmouth-Hitchcock Medical Center, but the Medical Center declined.

B. The Valuation Evidence

The Debtor and the City both introduced into evidence expert appraisal testimony and reports on the market value of the Property. Both experts determined that the highest and best use of the Property is its continued use as a health club facility with ancillary leased office space (“Highest and Best Use”) and based their opinions of value on the statutory definition of market value (“Market Value”).¹ However, they disagreed about the correct methodology for arriving at the Market Value for tax purposes. The Debtor’s expert used the direct income capitalization approach (the “Income Approach”) as the sole method of valuing the Property. The City’s expert used both the Income Approach and a methodology that determines value based on the depreciated cost to reproduce the Property (the “Cost Approach”).

The Income Approach, utilized by both appraisers, determines the value of an income producing property by first determining the stabilized net operating income (“NOI”) and then

¹ N.H. Rev. Stat. Ann. § 75:1 (1997) (“NH RSA”) provides that for purposes of taxation, “[m]arket value means the property’s full and true value as the same would be appraised in the payment of a just debt due from a solvent debtor.”

dividing it by a capitalization rate (a “Cap Rate”) to determine the Market Value for a property.² This approach is frequently used to value income producing real estate and is based on the premise that at a given rate of return for a real estate investment, an owner would pay a certain price to obtain the benefits of the expected future income stream. The use of the Income Approach is not straight forward, however, because the determination of NOI can be problematic. In addition, determining an appropriate Cap Rate is difficult because small changes in the determination of the Cap Rate can result in significant differences in Market Value.³

The Cost Approach, utilized by the City’s Appraiser, determines Market Value from the sum of the depreciated value of what it would cost to reproduce the improvements plus the estimated value of the land based on comparative sales data. The accuracy of this method is contingent on the availability of reliable comparable data to determine the value of the land and the validity of the assumption that in the eyes of a buyer, the value of the improvements is equal to their cost.

The Debtor’s expert, Robert Bramley (“Debtor’s Appraiser”), utilized the Income Approach to determine the combined value of the Club and the Property. Utilizing a Cap Rate of 21.14%, Bramley determined that the Market Value of the Club and the Property was \$2,600,000.00 as of April 1, 2001. From this value he subtracted the book value of the Club’s equipment (\$612,000.00) and a going-concern business value for the Club (\$298,000.00) to

² The Cap Rate is a reflection of the rate of return required by an owner, purchaser, or the market on the investment in a particular asset. For instance, an investor who required a rate of return, or Cap Rate, of 10% would theoretically be willing to pay \$1,000,000.00 for a property generating an NOI of \$100,000.00 per year.

³ For example, if the required Cap Rate in the example in footnote 2 was assumed to be 12%, the value of the property generating the same \$100,000.00 income stream would decrease by \$166,667.00 to \$833,333.00.

arrive at a Market Value of \$1,690,000.00 for the Property. The City's expert, David Rauseo ("City's Appraiser"), used Cap Rates of 10% for 2001 and 9% for 2002 to determine a Market Value for the Property of \$4,965,000.00 as of April 1, 2001, and \$5,564,000.00 as of April 1, 2002. Using the Cost Approach, the City's Appraiser determined the Market Value for the Property at \$4,712,000.00 as of April 1, 2001, and \$4,717,000.00 as of April 1, 2002. He reconciled the Market Values resulting from the two valuation approaches to arrive at his final opinion of Market Value of \$4,800,000.00 as of April 1, 2001, and \$5,000,000.00 as of April 1, 2002. Applying the NH Equalization Ratio agreed upon in the Stipulation, each appraiser's assessed value of the Property compares to the actual tax assessment by the City as follows:

	2001	2002
Debtor's Appraiser	\$1,487,200	\$1,487,200
City's Appraiser	\$4,224,000	\$4,400,000
City's Assessment	\$4,395,700	\$4,395,700

1. The Debtor's Evidence

The Debtor's Appraiser used only the Income Approach to value the Property. Based on his market analysis, he determined sales of comparable properties were too limited to rely on as a basis for valuation. In addition, he concluded the Club was over-built for its Highest and Best Use in the market. He, therefore, determined the Cost Approach would be inappropriate because no buyer would be willing to pay for the excess improvement costs. However, he did use sales comparison data to corroborate his conclusions regarding the appropriate Cap Rate.

The Debtor's Appraiser based his NOI on the Club's financial reports for 2001 through 2003 with the most weight given to the April 2001 through March 2002 period. Various adjustments to the NOI were made to allow for Club-specific issues. For example, he removed

real estate property taxes and management fees from the determination of NOI and accounted for them elsewhere in the Cap Rate, and decreased gross income to provide reserves for the replacement and improvement of the building, equipment, and furnishings. After adjustments, he concluded the Club's stabilized NOI was \$551,000.00.

To determine the appropriate Cap Rate, the Debtor's Appraiser analyzed the range of Cap Rates from four sales of facilities similar to the Club between 1993 and 2004. The sales varied widely in geographic location and market and had Cap Rates ranging from 15.2% to 19.6%. In general, Cap Rates are set to reflect risk. Therefore, the higher the risk, the greater return required to offset that risk. The sales with the two lowest Cap Rates were in Haverhill, Massachusetts, and outside Burlington, Vermont, markets that he deemed to be less risky than Lebanon. The sale with the highest Cap Rate was in western Massachusetts and was judged to be riskier than Lebanon. The 1995 sale of an athletic club in Somersworth, New Hampshire, at a Cap Rate of 18.9%, was deemed to be the best comparable for Cap Rate purposes. In his testimony and appraisal report, the Debtor's Appraiser explained he selected a base Cap Rate of 18.5% to reflect the perceived risk due to the Club's history of financial problems and to reflect the Club's potential for higher earnings than the older, comparable facility located in Somersworth, New Hampshire, that sold in 1995, when interest rates were higher.

Finally, based on his belief that the Club was over assessed for real estate tax purposes, the Debtor's Appraiser did not account for property tax expense in determining NOI. Instead, he added 2.64%, the effective percent of value paid in property tax, to the base Cap Rate.⁴ Based on these assumptions, the Debtor's Appraiser developed an overall Cap Rate of 21.14%.

⁴ This percentage was determined by multiplying the 2001 tax rate by the equalization ratio (\$29.98 per \$1,000.00 of assessed value, times 88%, which equals 0.02638) and rounding up to 2.64%.

Utilizing the Income Approach, the Debtor's Appraiser divided his stabilized current income of \$551,000.00 by his overall Cap Rate of 21.14% to arrive at a value for the Club of \$2,606,433.00, which he rounded to \$2,600,000.00. Because this value included both the Club and the Property, the final value for the Property was obtained by deducting the depreciated value of the furnishings and equipment (\$612,000.00) and the going-concern value (\$298,000.00) to arrive at a final Market Value for the Property of \$1,690,000.00 as of April 1, 2001.

The Debtor called Richard M. Caro, Jr., President of Management Vision, Inc., and founder, past president, and director of The International Health, Racquet & Sportsclub Association ("IHRSA"), as an expert in valuations of the Club and the Property. The Court determined that Mr. Caro (the "Business Expert") could testify as an expert on the business of the Club but not as a real estate expert. The Business Expert valued the Club through the Income Approach. He testified that businesses similar to the Club, which owned real estate, sold at earning multiples between five and seven, or Cap Rates between 14.29% and 20.00%. In addition, businesses similar to the Club but that lease their facility sell at earning multiples of three to five, or Cap Rates of 20.00% to 33.33%. He felt a Cap Rate at the high end of the range for health facilities owning their own real estate, or 20.00%, was appropriate based on several factors, including the Property being overbuilt for the Club's market, the market having little growth potential, and the troubled history of the Club's operations.

The Debtor also called two witnesses who have experience managing the Club to testify in response to the City's Appraiser's assertion that certain areas of the Club that currently are being used as program space should be converted into leased office space. Specifically, the

City's Market Value is based on a determination by the City's Appraiser that the Club is utilizing significantly more space than is necessary for the size of its membership and that the aerobics studio, a fitness room, the childcare center, and the café ("Proposed Conversion Areas") should be converted to office space for lease to third-party tenants.

Jennifer Warren Poljacik, the Club's group programming director in 2001 and 2002, testified that the Club would lose members if the recommended conversion took place. She testified that members would not tolerate the loss of an aerobics room or the fitness area because these areas have special improvements, such as lighting, special floors, lower ceilings, air conditioning, and privacy, which create the appropriate exercise environment for aerobics and personal training. She estimated that twenty to 30% of the members take aerobics and that 60% use the fitness area. She also testified that the loss of the childcare center would also lead to loss of members who depend on childcare while they are using the Club.

Joseph Asch ("Asch"), a principal of the Debtor and the general manager of the Club, also testified that loss of the Proposed Conversion Areas would have a serious negative impact on the Club's program and, therefore, on its membership. He testified that the Proposed Conversion Areas are some of the most highly used areas and that their loss would have been disastrous for the Club. He stated that the Club is positioned as a high-end club and that members pay high membership fees, up to twice what is charged by the community facility less than two miles away. At these rates, the members expect the availability of dedicated rooms and specialized services for aerobics and fitness. In Asch's opinion, the Club could not have survived the loss of membership that would have resulted from the combined effects of the program changes necessitated by the loss of the Proposed Conversion Areas and the Club's

chapter 11 bankruptcy in 2001. He testified that the Club's membership was based on a perception of stability, despite the chapter 11 proceeding. Furthermore, during the Determination Years, the Club was still recruiting new members who typically enroll for a year and then are members on a month-to-month basis. According to Asch, converting the highly used aerobics, fitness, and daycare program areas would be perceived as "cutting bone rather than fat" and would have a significant detrimental impact on the Club's recruitment and retention progress. Finally, he admitted the Club is housed in an over-built facility, but noted that the problem areas, such as the overly spacious hallways and locker rooms, cannot be economically converted into useful space.

2. The City's Evidence

The City's Appraiser used the Income Approach and the Cost Approach to determine the "As Is" values of the Property in 2001 and 2002. The City's Appraiser analyzed the subject neighborhood and market area, inspected the Club, and performed a highest-and-best-use analysis in performing his valuation analysis of the Property. As the Debtor's Appraiser had concluded, the City's Appraiser determined that a market approach to valuation was inappropriate in this instance because there were no sales of established health clubs in New Hampshire in the past five years.

Based on the construction of the facility, the City's Appraiser determined that continued use as a multipurpose health club with ancillary office space is the Highest and Best Use of the Property as improved. However, based on IHRSA national data regarding club size per member enrolled, the City's Appraiser determined the Club had excess capacity of about 9,700 square feet. Accordingly, the City's Appraiser recommended that the Proposed Conversion Areas be

converted to ancillary office and tenant spaces because they have easy access to the stairs and elevators.

Utilizing the Cost Approach, the City's Appraiser analyzed sales data from 1998 and 1999 for comparable tracts located in the same office park as the Club and determined that the value of the land, as of April 2001, was \$700,000.00 for 6.09 acres, or \$115,000.00 per acre. To determine the cost of the improvements, the City's Appraiser used the cost estimates provided by the Marshall Valuation Service (the "Marshall Service"), a nationally recognized building-cost service, which he compared to the cost to construct a hospital and the actual cost to construct the Club.⁵ Based on the Marshall Service figures, he estimated that the reproduction cost for the improvements in 2001 was \$4,626,050.00. This value was reduced for physical depreciation in the amount of \$254,500.00. In addition, a reduction for functional obsolescence in the amount of \$360,000.00 was made to reflect the estimated cost to fit-up the Proposed Conversion Areas for third-party tenant use. These adjustments resulted in a value of \$4,011,550.00 for the improvements in 2001. A similar analysis was used by the City's Appraiser to determine a value of \$4,016,829.00 for the improvements in 2002. Adding the value of the land to the reproduction cost estimates for the improvements resulted in values of \$4,712,000.00 for 2001 and \$4,717,000.00 for 2002 using the Cost Approach.

As was the case with the Debtor's Appraiser, the City's Appraiser also applied the Income Approach to determine Market Value. However, the appraisers' methodologies differed significantly. For example, rather than using the Club's actual operating performance as the basis for projected income, the City's Appraiser used estimates of the economic rent for all areas

⁵ The City's Appraiser did recognize that "actual construction costs may have exceeded traditional expected construction costs due to apparent inefficiencies in construction management."

of the Property. According to the City's Appraiser, the economic rent is defined as "the rental income that a property would most probably command on the open market as of the effective date of the appraisal" ("Market Rent"). The City's Appraiser examined the rents paid by the two third-party tenants located in the Property during the Determination Years as well as a "variety of leases of comparable office spaces in the . . . market area" to estimate the Market Rent for the Property. Based upon his review, the City's Appraiser determined that the average rent was \$13.00 to \$15.00 per square foot for the upper level and clear height lower level and \$12.00 to \$14.00 per square foot for the remaining lower level spaces. All comparison rents were on a triple-net basis based on rentals for office space in Centerra Park and a nearby medical center.

The City's Appraiser calculated the NOI based upon Market Rent of \$14.00 per square foot for the upper floor of the Club and \$13.00 per square foot for the lower level, because it has reduced views. He computed the gross operating income of the property by applying the Market Rents to both the portion of the Property he proposed for lease to third-party tenants and the portion used for the operation of the Club.⁶ Using the Market Rents, the City's Appraiser determined the gross operating income of the Property at \$721,864.00 per year. He then made adjustments for projected vacancies and operating expenses, such as a 6% management fee, a 3% reserve for replacement expenses, and 3% for miscellaneous expenses. Based on these Market Rents and adjustments, the City's Appraiser concluded the Club could generate an NOI of \$539,953.00 in 2001 and 2002.

The City's Appraiser developed his Cap Rate utilizing the mortgage-equity technique

⁶ As the basis for this determination, the City's Appraiser cited a recent trend in health clubs in New Hampshire and northern Massachusetts to lease ancillary spaces in their facilities and the fact that health clubs located in multi-tenant commercial spaces pay similar rent to other tenants.

which, in this case, applied a weighted average of debt and equity rates of return assuming debt financing of 75% and equity of 25%. He selected a debt financing rate of 9% based on local lending rates at this debt-to-equity ratio. He determined the equity-yield rate was 13% based on the comparatively high risk of leasing office and service properties balanced against the superior uses, demand, and stability of the leases in Centerra Park. Based on these rates, with adjustments for equity build-up and appreciation, he determined a blended Cap Rate of 9.8% was appropriate. After comparing his blended Cap Rate to the Cap Rate from a multi-tenanted office property sale in the Lebanon area in 2000, the City's Appraiser determined the appropriate overall Cap Rate for 2001 was 10.0%.

Using the Income Approach, the City's Appraiser divided his stabilized current income of \$539,953.00 by his overall Cap Rate of 10.0% to arrive at a value for the Club in 2001 of \$5,399,30.00, which he rounded to \$5,400,000.00. From this value, the City's Appraiser deducted the estimated cost to fit-up the Proposed Conversion Areas to leased space (\$360,000.00) and the cost to make identified repairs in the pool area (\$75,000.00) to arrive at a final Market Value for the Property of \$4,965,000.00 as of April 1, 2001. Based on lower mortgage rates and a higher adjustment for equity build-up, the City's Appraiser determined an overall Cap Rate of 9.0% for 2002. This resulted in a final Market Value for the Property of \$5,564,000.00 as of April 1, 2002.

The City's Appraiser reconciled the Market Values derived using the Cost Approach and the Income Approach for each year. He determined that the most logical buyer of the Club would be a fitness center that would rent ancillary spaces and experience above-average leasing performance because of the Club's good condition and location. Accordingly, he estimated the

Market Value for the Property to be \$4,800,000.00 for 2001 and \$5,000,000.00 for 2002.

III. DISCUSSION

A. The Legal Standard

Pursuant to the Stipulation, the sole issue before the Court is the determination of the Market Value of the Debtor's Property for the 2001 and 2002 tax years based on the real estate tax assessment standards under New Hampshire law.⁷ The property tax year runs from April 1 to March 31 with taxes assessed as of April 1 of each year. NH RSA 76:2. All real estate is subject to taxation at its market value. NH RSA 72:6; NH RSA 75:1. For purposes of taxation, "[m]arket value means the property's full and true value as the same would be appraised in the payment of a just debt due from a solvent debtor." NH RSA 75:1. The statutory language has been uniformly and consistently construed to require taxable property to be appraised at "the price the property would bring in a fair market, after fair and reasonable efforts have been made to find the purchaser who will give the highest price for it." Pub. Serv. Co. v. New Hampton, 101 N.H. 142, 146 (1957) (quoting Tr. of Philip Exeter Acad. v. Exeter, 92 N.H. 473, 481 (1943)). Accordingly, it is not the value to the current owner or the value of the current use that controls the value for tax purposes. Value for tax purposes is the value of the property at its highest and best use. Steele v. Town of Allenstown, 124 N.H. 487, 490 (1984); 590 Realty Co. Ltd. v. City of Keene, 122 N.H. 284, 285 (1982).

The New Hampshire Constitution mandates that all taxes imposed by the legislature be

⁷ In the Stipulation, the parties agreed that the Market Value for the 2003 tax year shall be the same as the Market Value determined for the 2002 tax year and that the NH Equalization Ratios shall be applied to the Market Values determined by the Court to compute the assessed value for the 2001 and 2002 tax years.

“proportional.” N.H. Const. Pt. 2, Art. 5. The Constitutional requirement of proportionality requires that all property within a taxing district, such as the City of Lebanon, be assessed for tax purposes at the same percent of its market value as all other taxable property within the taxing district. Pub. Serv. Co. of N.H. v. Town of Seabrook, 133 N.H. 365, 377 (1990). The burden of proving a particular property is assessed at a greater percent of its market value than other properties within the taxing district is on the taxpayer. Appeal of City of Nashua, 138 N.H. 261, 265 (1994). However, in this case, the proportion of Market Value to assessed value for tax purposes is established without any further evidence because the parties have stipulated that the NH Equalization Ratios shall be applied to the Market Value to determine assessed value for tax purposes. Stevens v. City of Lebanon, 122 N.H. 29, 32-33 (1982).

The expert appraisal witnesses for each party testified that the Highest and Best Use was as a health club facility, with ancillary office and tenant space. However, despite agreement on the Highest and Best Use, their Market Value determinations were significantly different. The Debtor’s Appraiser used only the Income Approach in his valuation of the Property. The City’s Appraiser used both the Income Approach and the Cost Approach in determining his opinion of value. Neither appraiser used the comparable sales approach. No one approach is correct in every case. All relevant factors to property value must be considered to arrive at a just valuation of a property. Paras v. City of Portsmouth, 115 N.H. 63, 67-68 (1975). It has been said that the determination of Market Value bears more than a passing resemblance to “a snipe hunt carried out at midnight on a moonless landscape.” Fusegni v. Portsmouth Hous. Auth., 114 N.H. 207, 211 (1974) (citation omitted). Flashlight in hand, the Court must review the evidence in the record which supports or refutes the conflicting opinions of the expert appraisal witnesses and

the facts and assumptions which form the basis for their opinions. The Court is not bound by the opinion of any expert witness and may accept or reject expert testimony in the exercise of sound judgment. Helvering v. Nat'l Grocery Co., 304 U.S. 282, 295 (1938); Appeal of City of Nashua, 138 N.H. at 264-65; Appeal of Net Holding Trust, 128 N.H. 795, 800 (1986).

B. The Opinion Evidence

The evidence on Market Value consisted primarily of the testimony and appraisal reports of the Debtor's Appraiser and the City's Appraiser. The Court finds that both appraisers are qualified, experienced, and credible. The parties agree that the starting point for determining the tax assessment for the Property is its Market Value. The parties even agree on the definition of Market Value. However, the Debtor contends the City's Appraiser based his opinion of value on erroneous assumptions regarding the average rental income the Property is capable of earning and on speculation that changing the use of the Proposed Conversion Areas would not adversely affect the operations of the Club. The City contends the Debtor's Appraiser did not adequately separate the business value from the real estate value, rendering his opinion of value unreliable and contrary to the standards for tax assessments applicable under the terms of the Stipulation.

For the reasons discussed below, the Court finds that the Debtor has presented sufficient evidence to establish that the valuation conclusions of the City's Appraiser, which support the assessed values used by the City for the Determination Years, exceed the true Market Value of the Property in those years. The Court also finds that the valuation by the Debtor's Appraiser did not adequately separate the business value of the Club from the real estate value.

Consequently, the Court is unable to utilize either appraisers' ultimate opinion of value to determine the Market Value of the Property for the Determination Years. However, the Court

finds that portions of each appraiser's data and analysis in the record before the Court may be utilized to support findings on the Market Value of the Property for the Determination Years.

1. Proposed Conversion Areas

The Debtor's Appraiser and the City's Appraiser agree that the Highest and Best Use is as a multi-purpose health and fitness facility. The Debtor and the City also agree that the Property is overbuilt for the Highest and Best Use given the market limitations in the Upper Valley. However, they disagree about the impact of the agreed-upon excess building capacity. The City's Appraiser used national data by IHRSA, a health association trade group, to determine the Club should require 12 to 14 square feet per member. Based on the Club's membership level of 2,400 during the Determination Years, he estimated the Club should have only require 24,000 to 33,600 square feet of space as opposed to the 41,884 square feet actually used for the Club's operations during the Determination Years. Based on his analysis of IHRSA data, the City's Appraiser examined the Property and determined the Club could convert 5,760 square feet of space used for Club operations (the salon/daycare area and the fitness and aerobics spaces) to rental office space together with the 3,950 square foot café area, leaving 37,724 square feet of space for Club operations. The City's Appraiser believes the market for office space in the vicinity of the Property supports his conclusion that the net operating income potential of the Property could be increased by offering excess space for rental.

The Debtor challenges the loss of the Proposed Conversion Areas based on the adverse impact on membership from the loss of the fitness, aerobics, and daycare areas. The Debtor presented testimony on the likely adverse effects of these changes and questioned the qualifications of the City's Appraiser to determine the impact of program changes to the Club's

operations. The City argued that the burden of proof on whether the Club could operate in a reduced amount of space that still exceeds the average amount of space used by similar facilities across the country rests on the Debtor, not the City. The Debtor counters that much of the over capacity in the Property is in excess corridor, common area, locker room, and shower spaces, none of which can be economically reduced. Therefore, the Debtor contends the analysis by the City's Appraiser is simplistic and does not take into account the unique features of the Property, as constructed.

The Court finds, on the record in this case, that the Debtor has satisfied its burden to show the Club could not operate successfully after the loss of the program areas included in the Proposed Conversion Areas. The Debtor presented testimony regarding the adverse impact on its operations, membership levels, and income from the loss or relocation of the daycare space and some of the aerobics and fitness spaces. In addition, the Debtor offered testimony that much of the apparent excess space utilized by the Club was in poorly designed shower, locker room, and corridor spaces that are not able to be readily reconfigured for use by the Club or third-party tenants. The City's only rebuttal evidence was the results of IHRSA's national survey. Furthermore, the City's Appraiser admitted he did not have any expertise or experience in the operation of health and fitness clubs. While the national data strongly suggests the Club's operations could theoretically be carried out in less space than is currently utilized, the record before the Court compels a contrary finding based upon the unique characteristics of the Property. The Court notes that the conversion of the café area involves space not currently utilized for Club operations and was not opposed by the Debtor. Accordingly, the City has established that any additional value, which could be obtained by utilization of the café space,

can be used to determine the Market Value of the Property.

2. Net Operating Income Evidence

In his Income Approach valuation, the City's Appraiser developed what he considered to be comparable market rents, which he then applied to the Property to determine its potential gross income. Based on rental data for office, service, and medical uses in the immediate vicinity of the Property, he determined the Market Rent for the upper level and high clear lower level of the Property (areas with views and ground level exposure) was \$14.00 per square foot on a triple-net basis and \$13.00 per square foot on a triple-net basis for the remaining lower level. After determining the gross rental income potential based on his Market Rent conclusions, and making reductions for vacancy, credit loss, property management, reserves for replacement, and miscellaneous expenses, he arrived at an NOI for the Property of \$539,953.00. The Debtor contends the City's Appraiser's Market Rent assumptions are not relevant in the real world to the buyers and sellers of health clubs and, therefore, cannot be used to determine the value of the Property. The Court does not agree with the Debtor. Valuation of real estate for tax purposes in New Hampshire is informed by the owner's use of the property, but is not controlled by that use. Steele v. Town of Allenstown, 124 N.H. 487, 490 (1984); 590 Realty Co. Ltd. v. City of Keene, 122 N.H. 284, 285 (1982). The value of a property for tax purposes must be based on its highest and best use, not its actual use. Steele, 124 N.H. at 490; 590 Realty Co., 122 N.H. at 285. Accordingly, the Court must determine if the Market Rents utilized by the City's Appraiser in his Income Approach to valuation represent the potential income of the Property at its Highest and Best Use.

The City's Appraiser concluded the Highest and Best Use of the Property was for

“continued use as a health club facility, with ancillary office and tenant spaces.” Based on his appraisal report and testimony, the rental expense attributed to the Club’s space, even after a reduction in space to account for the rental of the Proposed Conversion Areas, is computed by the Court as follows:

Space	s.f.	s.f.	Market Rate	Market Rent
Total Upper Level and High Clear Lower Level		28,522		
Less:				
Salon/Daycare	2,400			
Café	3,950			
Fitness Space	1,600			
Total		7,950		
Net Upper Level/High Clear Lower Level used by Club		20,572	\$14.00	\$288,008.00
Remaining Lower Level		24,812		
Less:				
Ciofreddi Rental	4,800			
Upper Valley Neurology Rental	1,100			
Aerobic Space	1,760			
Total		7,660		
Net Lower Level used by Club		17,152	\$13.00	\$222,976.00
Total Club Space		37,724		\$510,984.00
Average Club Rent Rate	\$13.55			

The City’s Appraiser based his proposed reduction in the space utilized for Club operations on IHRSA data and concluded that even with the proposed reductions the Club could service an expanded membership level of 2,750 to 3,200 members. In his highest-and-best-use analysis, he notes that the Club’s current membership approximates 2,400 and that its annual membership fee is \$996.00, exclusive of a one-time enrollment fee. He cites surveys indicating that as many as 5,000 people in the Upper Valley region would express a strong likelihood of joining the Club. However, he did not base his Income Approach valuation on any increase in

membership. In his analysis, he identifies four competing health and fitness facilities in the Upper Valley market with a range of annual membership fees between \$326.00 and \$598.00 per year. Accordingly, the Club's charges are substantially higher (\$398.00 per year or 66% higher) than the next lowest competitor. Therefore, the prospect for a significant increase in membership for the Club appears problematic.

In contrast to the City's Appraiser, the Debtor's Appraiser used the actual net income from the operations of the Club to determine the value of the Property by the Income Approach. In his analysis, he determined that the net income from the Club's entire operations for the Determination Years was \$551,000.00. Because that net income amount included rental income from the existing tenants (Ciofreddi and Upper Valley Neurology), the actual net income from solely the operations of the Club itself is lower than this number. According to the report by the Debtor's Appraiser, the average rental income from third-party tenant spaces during the 2000, 2001, and 2002 tax years was \$47,192.33.⁸ Subtracting this amount from the Club's net operating income of \$551,000.00, the average net income from the Club's operations during the Determination Years was \$503,807.67.⁹ Therefore, the Income Approach valuation by the City's Appraiser is based on the Club paying an imputed rent (\$510,984.00) that exceeds the actual income from its operations (\$503,808.00).

It may be the Club's operations were not run as effectively and efficiently as possible. Furthermore, there is a possibility membership levels have been higher. Nonetheless, even if the membership levels were at the 2,750 or 3,200 levels deemed theoretically possible by the City's

⁸ $\$45,337.00 + \$59,044.00 + \$37,196.00 = \$141,577.00 \div 3 = \$47,192.33.$

⁹ Net income of \$551,000.00 less third-party rental income of \$47,192.33.

Appraiser (a 14.6% to 33.3% increase), the proportionate actual increase in income would require that 88.5% to 76.1% of actual income be devoted to rental expense before payment of real estate taxes.¹⁰ However, no evidence was presented which would justify projected membership levels at those theoretical levels. In addition, if all, or substantially all, of the Club's net operating income was rent for its use of the Property, then no return on an owner's investment in the nontaxable assets of the Club, such as equipment and good will, would be possible. Such a result would be incompatible with the Club constituting the Highest and Best Use of the Property. If the Club, operating at or near its maximum revenue potential, could not afford to pay the rent imputed to it by the City's Appraiser, then there is an apparent contradiction or inconsistency in his analysis. Either his Highest and Best Use determination is wrong, or his Market Rent determination is wrong. Since both appraisers agreed on the Highest and Best Use, on this record the Court must conclude the Market Rent used by the City's Appraiser is not appropriate when applied to the Highest and Best Use.

For the reasons discussed above, the Court finds the City's Appraiser's valuation under the Income Approach is either internally inconsistent or wrong with respect to the rent attributed to the Club. In addition, the Court finds merit in the City's argument that the Debtor's Appraiser's valuation under the Income Approach fails to meet the state law standard because it does not adequately determine the value of the Property separate from the value of the business operated by the Club. The Court, however, must make a determination on the record presented to it, not the record it wishes had been presented by the parties. Accordingly, the Court has no

¹⁰ This theoretical increase in income assumes that increases in membership result in a proportionate increase in actual net income and makes no adjustment for return on the non-taxable assets (equipment and going-concern value).

choice but to use whatever data and analysis is in the record to determine the Market Value of the Property.

C. Net Operating Income Determination

The Court finds that the City's Appraiser's approach to determining NOI more closely follows the requirement of New Hampshire law that the value for tax purposes is determined by the value of a property at its highest and best use, not the value to the current owner or the value of its current use. In contrast, the valuation by the Debtor's Appraiser more closely establishes the value of the current use, which is not the standard the parties agreed to in the Stipulation. Accordingly, the Court will base its determination of value on the City Appraiser's approach, although, for the reasons stated in the previous section, it will not utilize his Market Rent assumptions to determine the imputed rent for that portion of the Property used by the Club.

Although the Club operates as the undisputed Highest and Best Use for the Property, the Club does not earn sufficient net income to support the rent imputed to it by the City's Appraiser. Therefore, the Court must look elsewhere in the record to determine what income to use to value the Club's use of the Property. The record establishes that the Club's use of the Property is the Highest and Best Use, that it has achieved membership levels equal to 48% (2,400 ÷ 5,000) of its market, and that it is far and away the most expensive health and fitness facility in its market area. No evidence has been submitted that the Club's operations, other than the amount of space it uses, are inefficient or poorly managed. Accordingly, the actual income from the Club's operations is the best and only evidence in the record of the ability of the undisputed Highest and Best Use to pay rent for its space. The data in the record, however, must be adjusted to remove that portion of the net income attributable to non-taxable assets such as

equipment and going-concern value.

The Court finds the City has failed to establish a record to support the change in use for all of the Proposed Conversion Areas. Nonetheless, there is no dispute the café area can be converted to third-party tenant use. Furthermore, although the Court has determined it will not use the City Appraiser's Market Rent determinations for the portion of the Property used by the Club, the record does support the use of such rents for the areas of the Club that can be rented to third parties. Accordingly, the Court shall determine the NOI for the Property using the evidence presented by the Debtor's Appraiser to determine the potential market rent for the spaces used by the Club and the evidence submitted by the City's Appraiser for the spaces rented to third parties.¹¹ The Court's determination of the NOI for the Property, based on the evidence in the record, is as follows:

NOI per Debtor's Appraiser		\$551,000
Less: Average Third-Party Rental Income 2000-2003		(\$47,192)
Furniture & Equipment	\$612,000	
Going-Concern Value	\$298,000	
Total	<u>\$910,000</u>	
Divided by Cap Rate before real estate taxes	20.00%	
Income attributed to non-taxable property		(\$182,000)
Imputed Rent from Club Operations		<u>\$321,808</u>

¹¹ Although the Court is using data from the report of the Debtor's Appraiser to determine the value of the Club's assets not subject to real estate taxation, the Court shall use the Cap Rate determined by the Business Expert to determine the contribution to income by the business assets.

Third-Party Rental Income			
Ciofreddi Space	4,800	@ \$13	\$62,400
Upper Valley Neurology	1,100	@ \$13	\$14,300
Café	3,950	@ \$14	\$55,300
Rent from Third-Party Tenants	9,850		<u>\$132,000</u>
NOI			<u>\$453,808</u>

D. Capitalization Rate Determination

The Debtor's Appraiser determined that 18.5% was the appropriate Cap Rate to use in valuing the Property under the Income Approach. He based this determination on several factors. First, during the Determination Years the prime rate was 8.0% with loans for special-purpose facilities being made at rates three to four points above prime. Second, the history and risks associated with the Club's use of the Property indicated a higher risk premium. Third, the sale of a similar property in Somersworth, New Hampshire, in 1995, was made at a Cap Rate of 18.9%.

The City's Appraiser applied a Cap Rate of 10.0% for the 2001 tax year and 9.0% for the 2002 tax year. He based his determination for the 2001 tax year on a weighted average adjusted for several factors. He assumed a hypothetical buyer would finance the acquisition of the Property with debt financing for 75% and equity financing for 25%. After consulting local lending mortgage offices, he determined that mortgage rates during the 2001 tax year ranged between 8.5% and 9.5% based on a twenty-year amortization period and a 70% to 75% loan-to-value ratio. He determined equity investors required returns in the 10% to 12% range for "high quality real estate" but that required returns "may be higher for office and service commercial properties such as the [Property]." Based on this analysis, he determined that 13% was an appropriate equity return. He then computed a weighted average return, after adjustments, of

9.8% based on an estimated holding period of seven years and an assumed appreciation of 0.5% per year over the holding period. The weighted average was rounded, resulting in a Cap Rate of 10.0% for 2001. His analysis for the 2002 tax year was identical, except for the interest rate on the debt portion, which he determined was 7.0% resulting in a Cap Rate of 9.0% for 2002.

The Court finds the methodology utilized by the City's Appraiser interesting, but not supported by the record. The Cap Rate for 2001 is insignificantly higher than the prime rate, a result not in keeping with the history of the Property or the fact that it was constructed for a specialized use. For example, significant portions of the Property have high ceilings and other special features such as pools and showers, which would render it prohibitively expensive to change to an alternative generic use such as office space. Furthermore, it is undisputed the Property is overbuilt for the Highest and Best use. The Court does not find it credible that the risk associated with a special-use property whose primary tenant/user filed for chapter 11 bankruptcy protection warrants only a 0.5% to 1.5% premium over the prime interest rate.

Similarly, the Cap Rate determined by the Debtor's Appraiser is not supported by the record. After stating that special-use properties require a three- to four-point premium over the prime rate, or 11% to 12% in this case, he determined that a rate of 18.5% is appropriate based upon general recitations of risk and a single sale of a comparable property in southeastern New Hampshire in 1995 at a Cap Rate of 18.9%. The record does not justify a final Cap Rate essentially equal to the Somersworth sale without more support. Such support is not in the record before the Court.

Based on the record, the Court concludes that each appraiser found the endpoint of the range of reasonably possible capitalization rates that was most beneficial to its client. The

record does not contain sufficient evidence for the Court to conclude that one end of the range of reasonably possible Cap Rates is more likely than the other to be correct. Accordingly, the Court shall simply use the mid-point of the range established by the appraisers for each year. The Court determines that the base Cap Rate for the 2001 tax year is 14.25%¹² and the base Cap Rate for the 2002 tax year is 13.75%.¹³

E. Court's Determination of Value

The determination of value by the Income Approach is obtained by the simple mathematical exercise of dividing the NOI by the Cap Rate. However, because the Court has utilized the NOI determined by the Debtor's Appraiser for that portion of the Property used by the Club, the Court shall adjust the Cap Rate for that portion in the same manner as the Debtor's Appraiser to account for real estate taxes. No such adjustment is necessary for the portion of the Property where the NOI was determined using the City's Appraiser's rental rates, because the rental rates are determined on a triple-net basis. The value determined using the Income Approach will be reduced by the estimated cost of improvements to the café area to permit the rental income imputed to that space by the City's Appraiser.¹⁴ Accordingly, the value of the Property using the Income Approach is determined by the Court as follows:

¹² $10.0\% + 18.5\% = 28.5\% \div 2 = 14.25\%$.

¹³ $9.0\% + 18.5\% = 27.5\% \div 2 = 13.75\%$.

¹⁴ 3,950 square feet times \$30.00 per square foot for improvements equals \$118,500.00.

	2001	2002
Imputed Rent from Club Operations	\$321,808	\$321,808
2001 Cap Rate Adjusted for Real Estate Taxes (14.25% + 2.64% = 16.89%)	16.89%	
2002 Cap Rate Adjusted for Real Estate Taxes (13.75% + 2.64% = 16.39%)		16.39%
Value of Club Space	<u>\$1,905,317</u>	<u>\$1,963,441</u>
Gross Potential Income from Rental Space	\$132,000	\$132,000
Less: vacancy and credit loss (15%)	<u>(\$19,800)</u>	<u>(\$19,800)</u>
Effective Gross Rental Income	\$112,200	\$112,200
Less: property management (6%), reserve for replacement (3%), and miscellaneous (3%)	<u>(\$13,464)</u>	<u>(\$13,464)</u>
NOI from Rental Space	<u>\$98,736</u>	<u>\$98,736</u>
Cap Rate	14.25%	13.75%
Value of Rental Spaces	<u>\$692,884</u>	<u>\$718,080</u>
Income Approach Value	<u>\$2,598,201</u>	<u>\$2,681,521</u>
Less: Café improvements	<u>\$118,500</u>	<u>\$118,500</u>
Final Market Value	<u><u>\$2,479,701</u></u>	<u><u>\$2,563,021</u></u>

The Market Values determined by the Court through the Income Approach, rounded off, are:

2001	\$2,480,000.00
2002	\$2,563,000.00 ¹⁵

¹⁵ Based upon these Market Values and the Stipulation, the assessed values for the Property would be:

2001	\$2,480,000	x	88%	=	\$2,182,400
2002	\$2,563,000	x	88%	=	\$2,255,440

F. Reconciliation of Income Approach and Cost Approach

The Cost Approach values obtained by the City's Appraiser are \$4,717,000.00 for both 2001 and 2002. The Court shall not use the values developed by the Cost Approach for several reasons. First, these values are based on estimates for the construction of the Property without any reduction for those portions that the undisputed evidence demonstrates are overbuilt (e.g. corridors, lock/shower facilities, and Proposed Conversion Areas). Second, the value developed under the Cost Approach is over 180% more than the value determined by the Income Approach based on the evidence in the record before the Court. Third, it is not likely a willing buyer would pay reproduction-cost prices for special improvements for the Highest and Best Use if those improvements could not generate an appropriate return. Therefore, the Court will use the values determined by an Income Approach to valuation based on the evidence in the record.

III. CONCLUSION

For the reasons set forth in this opinion, the Court finds that the Market Value of the Property was \$2,480,000.00 on April 1, 2001, and \$2,563,000.00 on April 1, 2002. This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052. The Court will issue a separate order consistent with this opinion.

ENTERED at Manchester, New Hampshire.

Date: March 7, 2006

/s/ J. Michael Deasy
J. Michael Deasy
Bankruptcy Judge